Investing in China's Capital Markets: Where Will WTO-Sparked Reforms Lead?

Conference Report

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Foreword

The Asia Society is pleased to present the report of our conference entitled, "Investing in China's Capital Markets: Where Will WTO-Sparked Reforms Lead?" The conference, held at the Asia Society's headquarters in New York on May 9, 2002, featured executives whose companies are spearheading the impressive growth in China's markets from both sides of the Pacific, as well as academics and policymakers specializing in the rapid changes China's markets are currently undergoing.

Although the conference examined a variety of topics ranging from the state of China's equity markets to the future development of the bond markets, at the center of each session was the same fundamental question: will China's financial markets represent a viable financial opportunity for investors in the near term, or does the reform process have to run much deeper before China's markets can really be relied on to create wealth for the domestic economy and for investors? The conference speakers, as well as guests in the audience, expressed mixed feelings on this question, an ambivalence that permeates the report that follows. Nevertheless, clearly emerging from the conference was a sense that the development of China's capital markets has quickly gained the attention of investors everywhere, and China will surely be a major financial investment destination in the future.

This conference would never have been possible without the commitment of our conference sponsors, O'Melveny & Myers LLP and JP Morgan Chase & Company. Dow Jones & Company has generously sponsored all of the Asia Society's 2002 Business Programs. We also received support from Morgan Stanley, State Street Corporation and Asian Venture Forum. The Asia Society would also like to thank Howard Chao for providing expert guidance on this project from the outset. The National Committee on US-China Relations was also helpful in collaborating with us to ensure the conference would be a success. On the Asia Society's staff, Judi Kilachand, Mike Kulma, Judite Lee and Allen Thayer all made important contributions. We are grateful to Feifei Lu for serving as conference rapporteur and to Justin Sommers for authoring the report. Thomas Connors edited the report, and Lai Montesca designed it.

This report is meant to reflect the range of the debate and the general viewpoint of the conference participants without implying endorsement of the recommendations by either the Asia Society, the author of the report, or the conference sponsors.

The Asia Society is firmly committed to providing ongoing forums to explore the development of China's economy in the months and years to come. This conference represents an important effort to fulfill that obligation.

Nicholas Platt
President

Robert W. Radtke
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Agenda

Welcome Remarks
- Nicholas Platt, President, Asia Society
- John Holden, President, National Committee on US-China Relations

Panel: How the Process of Raising Capital Will Change–the Investment Banking Perspective
- Cheuk Yuet Ho, Managing Director, BOCI Research Ltd.
- Patrick Hardy, Partner, O'Melveny & Myers
- John Langlois, Princeton University

Moderator: Henny Sender, Staff Reporter, The Wall Street Journal

Morning Keynotes
- Howard Chao, Chair, Asia-Pacific Practice, O'Melveny & Myers
- Carlos Hernandez, Managing Director & Global Head, Equity Capital Markets, JP Morgan

Panel: Reforming the Asset Management Industry
- Chen Yunxian, Chairman and CEO, GF Securities Co. Ltd.
- Sun Jianyong, Deputy Director General, Ministry of Labor and Social Security
- Vincent Duhamel, Principal and Chief Executive, State Street Global Advisors
- Mark Frazier, Lawrence University

Moderator: Daniel M. Schwartz, Chairman, AVCJ Ltd.

Luncheon Spotlight: Non-Performing Loans as an Emerging Asset Class
- Yang Kaisheng, President, China Huarong Asset Management Corporation
- David Bednar, Vice President, Asia-Pacific, Morgan Stanley

Panel: How China's Stock Markets Will Change–the Investor's Perspective
- Nicholas Lardy, Senior Fellow, Brookings Institute
- Kenneth Ho, Vice President - China Research, JP Morgan
- Yadong Liu, Managing Director, Medley Global Advisors

Moderator: Daniel M. Schwartz, Chairman, AVCJ Ltd.

Panel: Are Functioning Debt Markets on the Horizon?
- Oliver Fratzscher, Senior Financial Economist, World Bank
- Joydeep Mukherji, Director, Sovereign Ratings, Standard & Poor's Corp.
- Xing Yi, General Manager, Fund Investment Department, Ping An Insurance Co. of China

Moderator: C. Christopher Alberti, Managing Director, Taconic Alliance Group LLC

Introduction

In the coming years, the People's Republic of China (PRC) will increasingly rely on the development of its capital markets to fuel its economic growth. Yet the extent to which China's emphasis on capital markets will translate into opportunities for investors and financial services firms, particularly foreign firms, is a subject of much debate. Most experts agree that foreign firms servicing China's securities markets currently have limited ways to make a profit, but while optimists believe that China will represent a large and attractive market within five years, skeptics believe it could take decades for China to become a major international market for banks, brokerages and fund managers. Regardless of the debate, it is clear that domestic financial institutions, often in cooperation with foreign partners, have already started transforming a system reliant on state-owned banks into a system that will allow institutional investors to develop one of Asia's largest capital markets.

To explore China's potential to become a major financial center, the Asia Society organized a conference at its New York headquarters on May 9, 2002. Sponsored in part by O'Melveny & Myers and JP Morgan Chase and held in collaboration with the National Committee on US-China Relations, the conference attracted an audience of 250 China-focused investors, fund managers, economists and analysts. The relatively large turnout reflected the increasing interest in China as a destination for securities and investment firms, perhaps to an extent that exceeds the real immediate value China offers to them.

The conference's five main sessions addressed the following topics: the emergence of an investment banking sector; the development of domestic equity markets; opportunities to invest in non-performing loans; the nascent fund management industry; and the potential to develop a functioning bond market.

How the Process of Allocating Capital Will Change: The Investment Banking Perspective

The conference began with a roundtable discussion of China's emerging investment banking sector, and of the potential future opportunities for domestic and foreign banks looking to help Chinese firms raise capital domestically in the future. John Langlois of Princeton University offered an analysis of the outlook for the investment banking industry. Domestic investment banking services currently can only be offered by domestic banks, and even regional and private Chinese banks are restricted from such activities. The Chinese government really favors four government-owned financial institutions, which are able to enter a wide variety of financial services areas not open to regional commercial banks: Bank of China International (BOCI), China International Trust and Investment Corporation (CITIC), China Construction Bank and China Everbright. In investment banking, Bank of China and China International Capital Corporation (CICC), which is controlled by China Construction Bank, are the two main players. CICC currently offers a broader range of services, though Bank of China is quickly catching up.

According to Mr. Langlois, foreign competitors cannot join local stock exchanges or participate in domestic securities activities, and are therefore limited to competing for international stock and bond offerings by Chinese entities. The WTO protocols on financial services will not immediately change this situation in the near term. Furthermore, in a keynote address following the opening session, Carlos Hernandez of JP Morgan noted that a lack of liquidity in the markets forces investment banks to focus exclusively on large stock offerings. This further limits the potential clientele for investment banks in China.

However, Mr. Langlois pointed to a few activities that could offer significant upside potential for foreign firms in the future, including occasional international bond underwritings and IPO opportunities, and the purchase of non-performing loans from asset management corporations (AMCs). Despite China's annual economic growth rates of 8% to 10% since 1995, China's domestic corporate bond market has not grown in seven years, suggesting that China's financial markets are imbalanced toward the international side. In March 2001, China National Offshore Oil Company (CNOOC) issued a 10-year fixed-rate bond, China's first international corporate bond since 1999. The bond offering was eight times over-subscribed, with prices comparable to well-known Hong Kong issues such as Hutchison Wampoa, and without the premium investors typically require to hold Asian bonds. Although volumes still remain small, China is an attractive market for sovereign bond underwriting. China stands out among Asian sovereign credits, with bonds priced attractively to the issuer, even compared to developed markets such as South Korea. Foreign firms are also interested in other kinds of lending activities, such as financing home mortgage loans through securitization, but are currently restricted from such markets (for a more detailed discussion of China's bond market, please see Session 5 below).

In terms of international IPOs, the Chinese government has been working to privatize state-owned assets, and although progress has been slower than investors would like, Mr. Langlois cited the sale of assets in three oil and gas companies – PetroChina, Sinopec and CNOOC – over the past year and a half as cause for optimism. With each successive IPO, a greater percentage of the companies were sold to foreign investors, from just 10% in the PetroChina IPO on the New York Stock Exchange in April 2000 to as much as 29.4% in the CNOOC IPO on the Hong Kong and New York Stock Exchanges in February 2001.

This increase demonstrates the government's understanding that the share valuations of assets are dependent on the size of the stake held by public, non-state shareholders, including foreign shareholders. CNOOC, with a relatively small workforce, low debt, and strong revenue streams from its complete focus on the upstream side of the energy business, has outperformed other state-owned enterprises, and is evidence that the government is learning how to restructure its assets for sale on international capital markets.

Perhaps the most available opportunity for foreign investment firms at this stage is in China's non-performing loans (NPLs). China's four asset management corporations were set up to relieve state-owned banks of their non-performing assets and auction them off to investors at discount prices. Purchasing non-performing assets from the AMCs, a process discussed in greater detail in Session 3 below, has become a viable way for foreign investment banking firms to gain a foothold in the domestic renminbi market, which would otherwise be inaccessible to them. Morgan Stanley and Goldman Sachs recently negotiated for the purchase of about $1.3 billion of these assets from China Huarong Asset Management Corporation, a purchase that Mr. Langlois said showed boldness on the part of the banks' managers. The AMCs, whose loan portfolios represent a face value of $171 billion, could offer many more opportunities for investors willing to take risks in order to increase their presence on the mainland.

Mr. Langlois praised the China Securities Regulatory Commission (CSRC), China's financial services industry regulator, for its bold reform agenda. Although currently reform is not occurring rapidly enough for foreign investors, China's regulators have demonstrated that they are up to the challenge of opening up the financial services industry to foreign participants in the near future.

Chuek Yuet Ho of Bank of China International provided a look at how domestic banks will be able to take advantage of the process of raising capital on the mainland. His remarks helped to confirm Mr. Langlois's view of Bank of China as one of the few major participants in a very closed domestic industry.

BOCI is based in Hong Kong, though as the investment banking arm of Bank of China, it has all the connections of a mainland bank. Mr. Ho pointed out that as a state-owned bank, Bank of China will be acutely aware of policy changes in Beijing. Moreover, with another 18 months before the Chinese government will grant licenses to multinational banks to offer stockbroking services in China's dominant A-share market, BOCI has time to build its presence on the mainland without any immediate competition.

Mr. Ho said that in the short term, China's financing needs would be overwhelming, and he cited three main sources for funding them: first, the government will have to sell off state shares to raise money for its pension liabilities; second, state-owned enterprises will need to raise capital, as commercial banks, smarting from their buildup of non-performing loans, will curb their lending; third, he estimated that the state banks, including Bank of China, will need another 1 trillion renminbi to recapitalize the banking system. Over the next three years, therefore, a great deal of listings will be needed, thereby providing the real opportunity for investment firms. Given the lack of competition, BOCI will be well-positioned to take advantage of these investment banking opportunities, and Bank of China's large retail banking arm will provide valuable support to its investment banking business.

In his keynote address later that morning, Howard Chao of O'Melveny & Myers

explained that despite this lack of a level playing field, virtually all of the major international financial institutions view the Chinese market as a strategic imperative. Moreover, although foreign firms will only be able to achieve a small absolute market share in the short run, their impact will be disproportionately significant, and their anticipated arrival has already created a new competitive drive within many Chinese institutions. Domestic second-tier institutions have been scrambling for tie-ups with foreign partners, and while some foreign institutions will try to go it alone, most appear to prefer forging alliances with local partners. Most Chinese institutions are trying to upgrade their systems, product lines and management to gird themselves for international competition. Mr. Chao said that ultimately, foreign institutions will take market share away from the Chinese institutions, but the market is big enough for everyone, and the government will find ways to ensure that Chinese institutions retain the lion's share.

During the first session of the conference, Patrick Hardy of O'Melveny & Myers presented some of the problems with raising capital for Chinese companies domestically, and suggested that Hong Kong remains a more attractive destination for companies seeking capital. China lacks a strong base of institutional investors, which encourages speculative investment that ultimately hurts listed companies. China's stock market valuations are primarily driven by its 60 million retail investors, whereas institutional investors engage in roughly 60% of trading in Hong Kong, thereby providing greater liquidity. China's B-share markets, the only domestic stock markets open to foreign investors, remain incredibly small and are largely irrelevant.

Furthermore, with the mainland's listed companies only allowed to issue new shares every 12 months, Hong Kong affords more opportunities for companies to continue to raise capital in the months following an IPO. Equity instruments on the mainland are also highly limited at the moment, as only ordinary shares can be issued. China may soon permit qualified institutional investors from the mainland to invest in the Hong Kong market and allow Hong Kong to be the first place to permit offshore trading in certain RMB-denominated financial instruments. These measures would make Hong Kong an even greater part of domestic investing.

Finally, because of the lack of supply of equities in the market, many Chinese issuers receive high valuations in spite of the government's decision to end the use of official quotas to determine how many companies can list each year. Because the demand to list is much greater than the regulators' willingness to approve new listings, the government continues to make qualitative assessments of companies applying to list. The overvaluation of equities caused by this bottleneck of listings is an important issue for foreign investors looking for good values.

Because of these domestic constraints, Chinese companies have frequently sought overseas capital, particularly in Hong Kong. The first way they did this was by having their PRC-incorporated shares listed directly in Hong Kong. The tactic of offering these shares, known as H-shares, was pioneered by Tsingtao Brewery Co. in 1993, and since that time 59 other Chinese companies have issued H-shares in Hong Kong, representing less than 7% of Hong Kong-listed stocks. The second and more common way to list in Hong Kong has been for a Chinese company to establish a separate entity incorporated outside the PRC, and list that offshore entity in Hong Kong. Many of these offshore vehicles are "red-chips"– companies that are

at least 30% directly owned by the Chinese government. The third route for Chinese companies looking to list overseas is by "backdoor listing," in which PRC assets are injected into overseas companies in exchange for a controlling interest in the company. This method effectively ended in 1997, when the State Council announced that PRC entities hoping to list in this fashion needed state approval, which has been invariably denied.

With regard to whether or not Hong Kong will remain an attractive place for Chinese companies to raise capital as the mainland's equity markets mature, Mr. Hardy argued that Hong Kong will continue to be an important place for Chinese firms in the years ahead, regardless of the growth of China's domestic exchanges. First, Hong Kong's obvious advantages–a free flow of capital, a stronger regulatory framework and legal system, and an adherence to international accounting standards–will not change. Despite recent improvements and continued efforts on the part of the CSRC to enforce best practices, Chinese regulators still have not adequately dealt with fraud and market manipulation, while transparency and financial disclosure still fail to meet foreign investors' requirements. These concerns will remain, even as China begins to open up its A-share market to investors. While it is unclear how long Hong Kong will be the desirable capital-raising destination for domestic companies, it seems apparent it will at least be for the foreseeable future.

Following their presentations, the panelists briefly discussed the implications of this investment climate for private enterprises and start-ups seeking to raise capital in China. One panelist pointed out that in order to list in China, a company is required by the CSRC to have a three-year track record of profitability, a regulation that makes it difficult for start-ups to go public. Furthermore, if private companies need to raise debt, the market is highly regulated and skewed against smaller companies. Because commercial banks are unable to price risk efficiently and are overwhelmed by non-performing loans, they are largely unwilling to lend to small companies unless the company is foreign-invested. These circumstances do not bode well for private companies looking for fresh sources of capital in China.

The panelists did caution that, for the most part, even if private enterprises could list, they might not represent attractive investments. They often have unreliable financial statements and a murky ownership structure–even private companies listed in Hong Kong are often at least partly owned by the Chinese government, or by organizations such as the People's Liberation Army. Investors interested in private companies need to do thorough background checks to ensure that their investments will not blow up six months down the road.

Mr. Ho argued that because of these obstacles and because of the state's promises to restructure various industries over the next two years, the bulk of the opportunities for foreign investors and investment bankers will be in future sales of state-owned shares. Because the government has made these privatizations and restructurings such a priority, China will remain a place where government policy will be the primary factor in determining which companies list.

How China's Equity Markets Will Change: The Investor's Perspective

Following the discussion on the process of listing and issuing securities, the conference explored the current state of China's equity markets and, more importantly, the extent to which the stock markets will change in the near future. This will be a key issue for investors who are trying to determine whether China's equity markets are reliable growth engines for companies, or if they will remain too volatile and illiquid to attract long-term investment.

In his keynote address, Mr. Hernandez noted that the key factors in developing equity markets anywhere in the world are liquidity and transparency. Recent decisions by major institutional investors such as CalPERS to pull out of certain Asian markets that lacked the proper liquidity and regulation have helped drive this point home. Mr. Hernandez reiterated that in China, liquidity is stifled and share prices are overvalued because only one-third of shares in state-owned companies are actually traded. Moreover, because there are two sets of listings on the equity markets, China's markets have effectively split the available liquidity and have created valuation distortions between the markets. He suggested the domestic markets fix these overvaluations and price distortions, or risk losing large amounts of capital to more quality markets.

The CSRC has enacted reforms that will improve this problem of liquidity. Foreign securities firms can now directly trade B-shares, allowing them to inject more capital and expand their role as market makers. Domestic investors with foreign capital are now allowed to invest in B-shares, a reform which will help alleviate some of the price distortions. Until foreign investors can invest in A-shares, however, prices will remain distorted. The CSRC also has allowed foreign firms to participate in the securities and fund management businesses through joint ventures with local firms. These changes will help bring to China sophisticated institutional investors who will be more critical of valuation distortions, and will replace the momentum investing currently driving the domestic markets with more fundamental investments. Mr. Hernandez said that although the CSRC's reforms would not open the markets to capital flows as much as allowing foreign firms to invest in A-shares would, he maintained that the reforms have generally been positive and on the right track.

The CSRC has worked to impose strict standards on listed companies, working to prosecute perpetrators of fraud and requiring companies to follow international accounting standards when disclosing financial performance. The CSRC now requires listed companies to publish unedited quarterly reports, which CSRC inspectors regularly check for accuracy. The CSRC has also stiffened the penalties for companies that fail to comply with disclosure regulations, recently de-listing three companies and revoking the securities licenses of five local accounting firms for improperly preparing financial reports. China's courts have also begun to hear cases brought against listed companies by aggrieved shareholders, an important development in the protection of minority shareholders. Mr. Hernandez acknowledged, however, that many potential investors will hold back until further reform is enacted and the proper amount of disclosure exists.

Nicholas Lardy of the Brookings Institute expanded on this notion in his presentation, saying that the shortage of financial transparency and the lack of a market-driven listing process are crippling China's equity markets. In his sobering assessment of the domestic stock markets, Mr. Lardy pointed out that although China's equity markets

now have greater market capitalization than Hong Kong's, this is not a helpful indication of the real investment in China's market. The amount of money actually being raised domestically through the stock markets is quite small, and pales in comparison to new loans coming out of the commercial banking system every year. Last year, total funds raised were about RMB 100 billion, whereas new bank loans amounted to RMB 1.3 trillion. In other words, China's commercial banks were 12 times more important in raising funds for Chinese firms last year than equity markets.

Mr. Lardy argued that not only is the equity market currently small, but that it shows no signs of becoming a significant source of funds for the Chinese corporate sector in the future. Capital raised through China's equity markets in 2001 was only about half of the 2000 total, and only 10% greater than it was in 1997. In 2001, capital raised through IPOs totaled RMB 45 billion, less than a third of the amount raised in 2000, and only about half of the amount raised in 1997. Yet the Chinese economy is currently about a third bigger than it was in 1997, meaning that new financing in the form of IPOs has sharply declined as a percentage of China's GDP over the last four years.

Because the domestic market is not functioning properly, most of the largest issuances have recently been going to international markets like New York and Hong Kong. This is by no means due to a shortage of funds in the domestic market–China boasts one of the highest savings rates in the world–but rather because institutional arrangements have not been conducive to making domestic capital markets work.

Moreover, the A-shares market has declined in the last year, in part because investors realized that the state had plans to sell a significant portion of the two-thirds share it currently holds in listed companies. The threat of state-owned shares flooding the market could cast a pall on the market for the indefinite future. Mr. Lardy suggested that instead of selling its shares off piecemeal on the market, the Chinese government might consider selling large stakes to strategic investors in exchange for real control over the companies. That could increase the government's revenue without significantly depressing shares that have already been issued on the market. However, because the Chinese government is probably not ready to adopt this approach to the problem, the outlook for the equities market as a vehicle for corporate sector funds over the next few years may not be particularly bright.

Kenneth Ho of JP Morgan found grounds for optimism in China's equity markets by focusing on their long-term potential. The market capitalization of the domestic stock markets rose to 46% of GDP in 2001, up from just 6% in 1995. Current levels still pale in comparison to the region's more developed markets, such as Singapore, Malaysia and Japan, where market capitalization constitutes around 140% of GDP. This indicates that China has room to grow as it continues to implement economic reforms and restructure its industries, and Mr. Ho estimated that at the rate China's equity market capitalization is currently going, it could be eight times as big by 2020.

However, the volatility of the markets is impeding their growth. Individual investors still dominate the A-shares market, with institutional investors representing just 0.48% of all investors in the market and 4.71% of free-floating domestic market capitalization. Because H-shares have traded in correlation with A-shares, the volatility caused by this retail-driven environment has

spread across the border to Hong Kong's markets as well.

Mr. Chao noted during his keynote address that foreign investors have not been eager to invest in China's capital markets, even when permitted to do so. The B-share market only represents about 3% of China's total market capitalization and about 7% of the equity funds raised in Chinese IPOs. Many B-shares are actually owned by domestic investors, and even before the B-share market was opened up to domestic investors last year, a large number of B-shares were surreptitiously held by Chinese citizens investing through offshore nominee relationships. The failure of the B-share market to attract significant foreign investment is one indication of the poor quality of disclosures and accounting standards of China-listed companies, and lack of investor confidence in the corporate governance of those companies. Cases of accounting fraud and insider dealing are too plentiful for minority investors not to be concerned.

The non-convertibility of the renminbi for capital account transactions, which the Chinese government credits with preventing the Asian Financial Crisis from sweeping into China, is unlikely to change as long as China's banking system remains frail. Due to the fact that Chinese domestic investors with foreign currency are now the primary players in the B-share market, however, China is apparently considering the issuance of Chinese depositary receipts that would permit certain foreign company shares to trade in China. There has also been talk of allowing qualified foreign institutional investors to trade on the A-Share market.

Yadong Liu of Medley Global Advisors looked at China's equity markets from a different perspective. He acknowledged that China's equity markets are not developing as rapidly as foreign investors would like. Since the early 1990s, China's leaders have used the equity markets as a policy instrument to facilitate a political objective–that is, to implement economic reforms without causing so much social dislocation as to create unrest. Equity markets more or less became the means by which China could spread the risk of funding state-owned enterprises (SOEs) throughout society. The SOEs, inefficiently run and unprofitable, would not have been able to stand on their own without a continued infusion of capital, and the government no longer wanted the banking system to bear the entire burden. The A-shares market, therefore, has essentially become the funder of these bankrupt SOEs, allowing them to stay afloat long enough to ease the severity of the layoffs currently taking place on a nationwide scale. As long as this larger political objective guides China's economic policy, the capital markets will probably not develop rapidly enough for foreign investors.

Mr. Liu argued that this is not a bad thing when compared to the alternative: if the SOEs had been allowed to go under, social unrest as a result of the mass unemployment and decline in output would have impeded economic development to a much greater extent than the inefficiency of today's markets. The SOEs have undoubtedly outlived their usefulness, but the question of when and how they should be phased out remains. Chinese leaders cannot afford to ignore these issues, and have therefore chosen the capital markets as the means to deal with them. Still, Mr. Liu is encouraged that despite the slow pace of development in China's equity markets, China's leaders understand the changes that need to take place. Moreover, China's WTO commitments will help enforce a timeline for

change that China's leaders will adhere to, although this timeline may be more gradual than investors might like. In the meantime, investors not happy with China's perceived use of its equity markets to support its ailing SOEs might do well to stay away for the immediate future. Mr. Ho shared Mr. Liu's belief that investors must keep in mind that China is an emerging market, and its equity markets therefore cannot be expected to exhibit the same characteristics as the more sophisticated Western markets.

Following up on the first session's discussion about the failure of the equity markets to provide capital to the private sector, the conference panelists closed the session with a consensus that the equity markets are not in a position to serve the interests of either foreign or domestic venture capitalists. While there has recently been talk of rectifying this situation, including the possibility of creating a second board for technology companies, Chinese officials are understandably reluctant to let this kind of measure go forward until Chinese investors can be better protected. Procedures have been established for allowing foreign-invested companies to list domestically in China, but it remains to be seen how many approvals will actually be given. Until such avenues open up, foreign investors looking for exits would be well advised to look at trade sales rather than at public listings.

Spotlight: Non-Performing Loans as an Emerging Asset Class

As a result of the misallocation of bank loans to the state-owned sector over the years, China's banking system has accumulated an enormous amount of non-performing loans (NPLs). While it is difficult to get an exact figure, the book value of these loans is believed to total over US$500 billion, and the number continues to grow. In the late 1990s, the Ministry of Finance established four asset management corporations (AMCs) to relieve the banks of these loans and resell them to investors at significant discounts.

In his presentation earlier in the conference, Mr. Langlois described the powers of these AMCs as "striking." They can borrow cheaply from the People's Bank of China, own equities, sell their own bonds, and underwrite securities. The AMCs are primarily responsible for purchasing NPLs from the four banks at book value, thereby providing the banks with a major subsidy to clean up their loan portfolios. Mr. Langlois noted that the business of auctioning off these non-performing assets has been developing rather successfully, and offers an opportunity to both domestic and foreign investors who are willing to take a chance on these assets and try to recover their underlying value.

The conference luncheon provided an inside perspective on NPLs as an investment opportunity. Yang Kaisheng of China Huarong Asset Management Corporation and David Bednar of Morgan Stanley were two key players in the first and only purchase of Chinese NPLs by foreign investors, when a consortium led by Morgan Stanley purchased a portfolio of NPLs from China Huarong, the largest of China's four AMCs, in November of 2001. Mr. Yang and Mr. Bednar offered their perspectives on the transaction, and on its implications for future investment in these types of assets.

Mr. Yang noted from the outset the enormity of China's NPL problem. He attributed the NPL crisis both to the original misallocation of the banks' resources and to the fact that banks have not found an effective way to resolve their non-performing assets within a reasonable period of time. Under China's banking regulations, the banks are not permitted to restructure the loans and transfer creditors' rights to other investors. This essentially has left borrowers with only two options: to fully repay their debts, or to repay their debts through liquidation when they are completely insolvent. Mr. Yang said that the majority of borrowers are somewhere between bankruptcy and being able to repay their debts in full, and this middle ground is an opportunity for outside investors to recover, or even increase, the assets' value through debt restructuring.

The establishment of AMCs with sufficient power to resolve the NPL situation has made this process possible. In China Huarong's case, the company had disposed of RMB 31 billion of non-performing assets by the end of 2001. RMB 15.8 billion of that total was recovered, a 51% recovery rate, and RMB 9.6 billion of the recovered loans was in cash, a 31% cash-recovery rate. Of the assets China Huarong has recovered, over 80% has been through debt restructuring, while less than 3% has been through liquidation. Mr. Yang said that China Huarong's resolutions over the past year have demonstrated the considerable investment value and profit margin that can potentially come from these investments.

Mr. Yang said that foreign investors will be a vital part of China Huarong's efforts to speed up the asset resolution process and improve the asset recovery rate. Last year's sale to the Morgan Stanley-led consortium has provided a blueprint for how such sales to foreign investors should take place. Under the

terms of the deal, the consortium paid $117 million for the batch of loans, which carried a book value of $1.3 billion. Mr. Yang stressed the importance of selling a portfolio of assets rather than a single asset, in order to make the deal more attractive to investors: the November 2001 portfolio consisted of 341 borrowers and a total of 3,000 loans, with the assets spread out over 40 different industry classifications and 18 different provinces. The portfolio was divided into five pools, creating flexibility for investors, who could invest in any number of the five pools. According to Mr. Yang, the auction was conducted in accordance with international fundamental practice regulating NPL sales, with information fully disclosed throughout the bidding process, and the procedures made public beforehand. Bidding was fair and transparent, and commercial secrets were protected. The auction was supported by China's regulators, as well as by the various Chinese government agencies involved in the process. While the purchase was still awaiting formal regulatory approval at the time of the conference, Mr. Yang expressed confidence that approval would come shortly, adding that the Chinese government has made it a priority to establish a clear legal framework for foreign participation. The details of this framework are still being ironed out, though provisional regulations officially permitting foreign capital to invest in NPLs were issued last year.

Mr. Bednar praised Mr. Yang and China Huarong for having the courage to be the first of the four AMCs to open up the market to foreign participants. Mr. Bednar admitted that he initially had been skeptical about investing in non-performing loans in China, but over the course of visiting the enterprises behind the loans, and through extensive due diligence, became convinced that not only could these assets be attractive investments, but that they could also represent a very important market to focus on in the future. He said that many of his colleagues and investors in New York who had to be sold on Chinese NPLs needed to come see for themselves the economic transformation and growth taking place in China. The free-market forces that have enabled the Chinese economy to grow by 7% to 8% per year are critical for investments in NPLs to work, because ultimately, this growth allows wealth to be created and creditors to be paid back. Most major NPL markets feature stagnant economies, which is how the loans build up in the first place, but China's NPL market defies this trend. The rapid growth of China's economy was evident to the investors in the consortium, who found that the non-performing assets in China Huarong's portfolio often represented factories that were still operating at 100% capacity and were still capable of making money.

Mr. Bednar was also impressed by the degree to which the Chinese government supported the AMCs in their efforts to sell off the loans. China's leaders have shown that they understand the importance of attracting international capital to help with the difficult work of restructuring some of the state-owned enterprises. Mr. Bednar said that, with the possible exception of South Korea, China has taken the most aggressive stance of all the countries Morgan Stanley deals with in trying to resolve the major problems of its banking system–and government support is especially important in China, where it is difficult to conduct business if it is not in line with Beijing's objectives. Finally, Mr. Bednar confirmed Mr. Yang's claim that the auction to the Morgan Stanley consortium was extremely well-handled and in line with international standards.

Mr. Bednar and the other investors shared a major concern going into the auction

regarding China's court system and the enforcement of creditors' rights. They came to believe that China is a place where rules matter and that, unlike in other developing countries, if Chinese officials want to enforce these rules, the apparatus to do so exists. Furthermore, the investors were pleasantly surprised by the meticulous record-keeping, not only at the banks, but also at the government's property collateral registry offices. This critical paper trail does not exist in many other markets. The government convinced the consortium's investors that building a strong basis for creditors' rights was a priority, and that the legal system could be used to generate leverage with borrowers.

Yet it remains to be seen how the regulatory and legal systems will develop. Mr. Bednar admitted that Mr. Yang might have opened the market up too quickly, before the regulatory framework could catch up. This is, of course, a problem throughout China's financial sector, as the regulatory system works to meet the commitments China's leaders made upon entry into the WTO.

The Future of the Asset Management Industry

The remaining two sessions looked at two areas of China's financial services industry that are still in the early stages of development, but which may carry potential for investors in the long run. "The Future of the Asset Management Industry" examined the opportunities for the development of fund management services, and the degree to which pension reforms currently underway will provide a much-needed boost to this industry.

Chen Yunxian of GF Securities gave an overview of the Chinese fund management market from the perspective of a domestic securities firm that is now one of the five largest in China. In Mr. Chen's view, the fund management industry has made measured progress since the first closed-end fund was established in 1997, and now boasts 51 closed-end funds and five mutual funds. All told, the fund market represents about RMB 85 billion in market capitalization and RMB 270 billion in trading turnover.

Yet Mr. Chen said that with funds' market capitalization representing just 5% of the A-share market, fund management had a long way to go before it would constitute a significant part of the markets. There are only 16 licensed fund managers in China, with a total of just RMB 2.2 billion in registered capital, and their investment choices are limited, for the most part, to A-share equities, government bonds and the few corporate bonds that have been issued.

Nevertheless, Mr. Chen said he was optimistic that growth in the fund management industry would accelerate in the near to medium term, partly because complex trading instruments such as futures and options will soon emerge. Given China's huge savings pool of about RMB 8 trillion, an increase in choices of trading instruments could entice China's savers to rush into the capital markets through these kinds of funds.

Perhaps the most critical factor will be the role foreign firms play in China's fund management industry. Following China's entry into WTO, foreign firms were immediately allowed to enter joint ventures with domestic fund managers. Foreign participants can currently take up to a 33% stake in these fund managers, and this number will be permitted to rise to 49% within three years. Mr. Chen believed the entry of foreign firms into the market would be beneficial for everyone. Domestic fund managers will gain access to foreign expertise and capital, while foreign firms will gain access to established distribution channels and rapidly growing client bases in return. GF Securities, for example, already has more than 100 branches on the mainland and 1.5 million customers who use their brokerage services to invest in the two domestic stock exchanges. Mr. Chen said GF's major aim in the near term is to attract a foreign partner to participate in a fund management joint venture.

Vincent Duhamel of State Street Global Advisors said Mr. Chen's feelings about the need for foreign partners were mutual. For foreign fund managers, the importance of joining with strong local players in developing their China business cannot be overstated, since foreign firms will be excluded from most areas relating to fund management for the next three to five years. Mr. Duhamel outlined various kinds of cooperative arrangements that foreign fund managers could enter into with local partners: alliances with domestic fund management companies that include future equity participation for the foreign firm; alliances with domestic securities funds to jointly apply for a new fund management license, which include immediate equity participation for the foreign firm; and alliances with domestic securities firms for institutional asset management business-

es such as pension funds. The CSRC has been strongly encouraging these partnerships.

While joint ventures may be a solution to a foreign firm's short-term market-entry problem, rushing into poor partnership structures might compromise future success, as has been the case in other industries in China over the years. Moreover, Mr. Duhamel said that many domestic fund management companies have not been inclined to share revenue benefits with foreign partners. While these companies welcome help from foreign partners to build up their infrastructure and to enter into new business areas such as open-ended mutual funds, they are very reluctant to share the revenues from their existing profitable businesses with their foreign partners. In comparison, Chinese securities firms that are currently looking to apply for fund-management licenses are more eager to find a foreign partner to enhance their credibility and increase their chances of getting a license. As a result, these firms are willing to yield a greater equity stake and more management control to their foreign partners.

In considering future competition between domestic and foreign firms, Mr. Duhamel said that right now, because of the lack of complex investment products available in the capital markets, competition in the fund management industry still centers on systems and operations platforms, as well as on sales, marketing and distribution management, rather than on investment product development and investment management. Among domestic firms, the current market competition is largely confined to return guarantees and profit-sharing schemes after minimum returns are achieved, and the strongest firms are the ones that win regulatory approval for more fund launches, a tightly controlled process. The companies with the most assets under management, and therefore more revenue, enjoy scale advantages over competitors.

However, as investors' demands evolve, and as regulators gradually loosen the approval process for both fund management companies and fund launches, the need for competitive product differentiation, and consequently the need for the expertise of foreign firms, will emerge. Although retail investors in China's equity markets are primarily speculators seeking high absolute returns, a recent survey by a leading Chinese securities firm found that 85% of individual investors do not simply want high absolute returns, but instead desire low-risk investment products that can beat bank deposit interest rates, which are expected to remain at 2% for the foreseeable future. Fund and asset managers have begun to emphasize risk management in their portfolios to meet this growing demand. With only a fraction of domestic savings invested in the equity markets thus far, there is tremendous potential for transfers of funds from bank deposits once the right investment products, structures and channels are in place. Demand for greater fund management products will increase the demand for experienced foreign fund managers and give them more leverage in their partnership arrangements with domestic firms.

Mr. Duhamel said that he sees pension reform as one of the driving forces behind the asset management industry going forward, and foreign firms will have much to offer the domestic pension fund industry, including advice, training, investment models and technology. Mr. Duhamel expressed confidence that that the regulatory environment for the asset management business is becoming clearer, and that large Chinese institutions and government agencies will increasingly turn to global providers for help in the areas of pension management, as well as in the broader fund and asset management industry.

Sun Jianyong of China's Ministry of Labor and Social Security (MLSS) addressed this

issue of the reforms taking place in the pension system, and the degree to which they will boost the domestic capital markets. Because the government can no longer afford to shoulder the pension burden of state-owned enterprises, it is attempting to spread out the responsibility of payment, and to delineate the specific responsibilities of the central government and the provincial governments in the process. Since the mid-1990s, the pension system has revolved around three pillars: a mandatory state-run pay-as-you go program, fully funded by employers and pooled at the provincial level; a mandatory defined contribution program to which both employees and employers contribute; and a voluntary supplementary program for employees to contribute further to their individual accounts. Beijing will gradually increase the role of individuals in providing for their own retirement (Pillars Two and Three), and will provide tax incentives for individuals to engage in voluntary contributions to their own plans.

More recently, the central government has established the National Social Security Fund (NSSF), a fund raised by the national government largely through sales of government stakes in SOEs and through budgetary allocations from the Ministry of Finance. The NSSF, which has about RMB 80 billion collected into it, bolsters the pay-as-you-go program by making up for shortfalls from bankrupt SOEs that are unable to contribute to the provincial pools. Mr. Sun said this fund will eventually accumulate "hundreds of billions" of renminbi through investment returns and increased cash injections from the government, although he did not offer a timetable to reach this target. New regulations issued by the State Council last year allowed the NSSF to invest up to 40% of its funds in equity markets. Most of the fund is invested in government bonds, but Mr. Sun added that the fund has begun to experiment with stocks and mutual funds. The government is currently drafting policies to allow the pension funds at the enterprise and individual levels to invest in mutual funds as well. Mr. Sun said this process would increase investment in the capital markets and aid in their development.

Ultimately, the MLSS's primary responsibilities will be to regulate the overall development of the pension fund industry and to standardize the pay-as-you-go program, the resources of which vary from province to province. In doing so, the government will set up well-defined standards for financial institutions trying to access the market to establish funds, trustees, investment management organizations, corporate annuity personal accounts, and so forth. Mr. Sun said that, as per China's WTO requirements, foreign firms will be able to compete for the same opportunities as domestic firms, and that the application process for foreign firms looking to access the market will be straightforward and transparent.

Mr. Sun acknowledged that Chinese regulators lacked the expertise and experience necessary to carry out the transformation of the pension system unaided, and appealed to foreign firms and overseas Chinese to work with and advise the government along the way.

Mark Frazier of Lawrence University expressed skepticism during his presentation that pension reform will be able to proceed as smoothly as Mr. Sun described, and detailed several of the serious challenges currently facing the pension system. Part of the problem is that, with 31 million retirees and 1.5 million new retirees eligible for pensions every year, the government's pension payment obligations are enormous, but demographic problems are just the beginning of the flaws in the system that may need to be worked out.

Until the mid-1990s, pensioners retiring from state-owned enterprises received their

entire pension–equal to as much as 75% of their final year's salary–directly from their employers, creating a huge burden for SOEs. Following the enactment of reforms, SOEs and non-state firms alike were required to pay a percentage of their wage bill to social insurance pools administered by municipal and provincial governments. These pools include pension, unemployment, healthcare, and other forms of insurance. However, because of the poor financial condition of SOEs, many are unable to pay their social insurance contributions. This shortfall in pension collections for future retirees makes it difficult for current retirees to receive their benefits. Moreover, the mandatory individual accounts of the second pillar are actually 'notional,' since contributions toward these accounts are being paid back out to current retirees rather than being placed in a pool.

Equally problematic is pension administration. Legally, managers of social insurance pools can only invest the funds in low-yield instruments such as treasury bills or time deposits at banks. While short-term obligations may necessitate a low-risk investment strategy, social insurance funds have been vulnerable to diversion. In the past, local governments have raided the social insurance pools to fund development and infrastructure projects, and the central government is having mixed success curbing these abuses. Local officials have leeway to determine the percentages that firms in their area pay into social insurance funds, and the tight fiscal conditions of many local governments provide them with an incentive to set high collection rates for social insurance. Local governments are also not always able to collect proper payment from local firms. Non-state firms are difficult to monitor, and are notorious for understating their workforces in order to pay smaller amounts into the insurance pools.

National statistics show that in 2001, authorities collected RMB 243 billion in pension contributions, an amount that exceeded payouts to current retirees. However, this small surplus was achieved by the central government transferring a subsidy of RMB 35 billion to provincial governments, and this subsidy is expected to grow astronomically over the next decade in order to cover shortfalls. Mr. Frazier concurred with Mr. Sun that a centralized system that replaces hundreds of provincial and municipal pools with one national fund would be more desirable. While the establishment of the NSSF represents an attempt to begin centralizing collection, it faces a funding problem. The sale of government shares in SOEs is one source of funding, although this policy was suspended in Fall 2000 when share prices tumbled due to fears that the government sell-off would cause an oversupply of shares. But the more serious obstacle to centralization arises from the fact that municipal and provincial governments do not want to relinquish control over pension funds that they have collected. Reflecting localism but perhaps also pragmatism, provinces with surpluses have refused to turn over pension money to the central government to give to provinces with pension deficits. And to date, provincial governments themselves have been unable to persuade municipal governments to turn control of their pension resources over to the provincial level.

In a presentation during a different session, Mr. Lardy also pointed out that as China goes from a pay-as-you-go system to a funded system, it will encounter an intermediate generation of people who will not have been building up funds for long enough to finance their retirements. Financing this transition will be a huge problem, and it is not clear that Chinese officials have a plan to do it.

Mr. Frazier's presentation challenged the notion that the pension system was close to

providing a boost to China's capital markets. Most of the social insurance pools and funds from individual accounts are being used to pay current retirees instead of being invested, and the little surplus that remains is not seeing any investment return because of the lack of available investment choices. The RMB 80 billion in the NSSF is the most likely to become invested in the capital markets, but that may be needed to subsidize provinces that cannot meet their current pension obligations.

The panel concluded that until the pension system is actually able to raise a surplus to invest, rather than using the sum of its various pension pools to fund current obligations, pension reform will fail to act as a driver for China's capital markets. The fund and asset management industries do have several drivers of growth, as the panel detailed. But pension reform will not be one of them, at least not in the short term.

Are Functioning Bond Markets on the Horizon?

Perhaps none of China's capital markets is less efficient than its bond market, and this inefficiency could undermine financial intermediation and limit future economic growth if unaddressed. Although China's government bond market has grown substantially, there is virtually no notable corporate bond market, and no present opportunities for investors that might represent substantial returns. This final session looked at what steps the government may take to develop an integrated bond market, and at what institutional investors will be looking for before they can consider it as a potential destination for investment.

Oliver Fratzscher of the World Bank presented a blueprint for the development of China's debt markets. He suggested the Chinese government implement a three-point plan: develop the capital markets, primarily by giving the state commercial banks access to them; build up a substantial base of institutional investors to drive the market; and introduce diversified investment instruments and liberalized interest rates. The World Bank has been advising the government on this issue for several years, and Mr. Fratzscher indicated that China's policymakers are progressing well to realize these priorities.

Mr. Fratzscher said that unless the large domestic commercial banks are allowed a stake in the capital markets, the markets will not be able to develop. The enormous amount of savings held as deposits in the commercial banks needs to be freed up for investment in the capital markets. Therefore, the commercial banks need to establish conglomerates with their subsidiaries becoming institutional investors. This will in turn require the banks to be better regulated, with improved corporate governance from what is currently in place. China's regulators have already allowed two of the big banks, Bank of China (through BOCI) and China Construction Bank (through CICC), to offer investment banking and securities services, and have allowed CITIC and China Everbright to form financial holding companies to engage in similar activities. The government needs to continue to allow the banks to enter the capital markets, and most importantly to invest in the bond market through vehicles such as fixed-income mutual funds. This kind of activity will pump liquidity into the market and open up an industry that is currently small and largely unregulated, and therefore risky. Allowing banks to become fund managers will also help provide superior returns to banks that are currently unable to earn money on lending. In late April, the People's Bank of China took a step in this direction by issuing rules permitting commercial banks to conduct a "financial derivatives" business, which would include interest rate and foreign currencies futures, financial futures, interest rate and currency swaps, and options on stock indexes, foreign currency, interest rates, and bonds.

These measures will be just the beginning of the government's efforts to build up a strong class of institutional investors–particularly pension funds, mutual funds and life insurance companies–that will be critical vehicles for chaneling the country's savings into productive investments. Financial innovation is often driven by such institutional investors, who can act as strategic investors to enhance competition and performance throughout the system. Currently, China's fund management industry is entirely equity-focused, and a recent study by the People's Bank of China estimated that 90% of fund managers are operating underground without approval from China's regulators. Mr. Fratzscher suggested the government lower entry barriers for fund managers, but regulate the industry more closely through passage of the proposed

Investment Fund Law. Insurance companies, already the fastest-growing segment among China's institutional investors, need to further develop their asset management arms and diversify their investments into Hong Kong's fixed income markets.

Of course, insurance companies need alternative investment vehicles if they are to act as professional asset managers. First, the government needs to liberalize interest rates so banks can make money on the spread between deposits and lending. This will also motivate depositors to move their savings into mutual funds and unit-linked products. The government needs to introduce hedging products such as short-selling, futures and options in order to mitigate investment risks. The market for government bonds and unlisted financial institution bonds has grown to US$300 billion, four times the size of Hong Kong's market. This government bond market should facilitate the development of the corporate bond market, creating a fluid market for institutional investors.

Xing Yi of Ping An Insurance Company of China confirmed Mr. Fratzscher's belief that Chinese insurance companies were too restricted in their investment options to be effective, forcing them to pour an enormous 52.4% of their assets into bank deposits.

Ms. Xing said that current capital market conditions make it impossible for Chinese insurance companies to achieve their asset allocation goals. The bond market is simply too small and offers too limited a selection of investments. The balance of the bond market currently stands at RMB 2.9 trillion. Treasury bonds account for 69% of the total market, financial bonds 29%, and corporate bonds less than 2%. Furthermore, almost 25% of the bonds is issued as non-tradable Treasury voucher bonds, so the tradable bond market actually stands at just RMB 2.2 trillion, approximately 25% of GDP.

Even the sizable Treasury market does not offer a rational distribution of products for institutional investors such as Ping An. Only 3.5% of tradable bonds in China are fixed-rate Treasuries with maturities of over 10 years. The undersupply of long-term bonds with higher interest rates means that the ability of Chinese insurers to match long-term liabilities with long-term assets is very limited. Further skewing the market is the fact that almost half of all Treasury bonds have a 7- to 10-year maturity, and bonds with maturities of less than one year have not been issued in recent years.

Liquidity in the bond markets is also strained, primarily because China's bond markets are divided into three segments–the Inter-bank market, the Exchange Market, and the Voucher Bond Market–all of which feature different participants. Trading rarely flows between segments, and the voucher bonds do not even have a public market.

Adding to the difficulty of investing in China's bond markets is the lack of an established interest rate yield curve. Since 1996, as the growth of China's economy has slowed, the People's Bank has cut interest rates eight times, driving the one-year interest rate for bank deposits down from 10.98% to 1.98%. Bond market yield has gone downward continuously as well, leaving little potential for investment returns in the market. Currently, 30-year bonds yield just 3.7%, well below yields on less risky US Treasuries with similar maturities.

Therefore, the bond investment selection Ping An faces is very limited. Nevertheless, Ms. Xing said Ping An expects the bond markets to become more integrated, as walls between the inter-bank and exchange markets have already begun to come down, and voucher bonds will soon be tradable. Furthermore, while the corporate bond mar-

ket has been miniscule, there have been flashes of successful large domestic bond offerings in the recent past, including recent issuances by the Ministry of Railways to finance railway development, as Mr. Langlois pointed out earlier in the conference.

Taking a step back from the technical aspects of building the market, Joydeep Mukherji of Standard and Poor's offered an analysis of China's debt market from the perspective of a ratings agency. Since sovereign ratings reflect the general risk associated with a country's bonds, the rating can serve as a general guideline for the corporate market when it develops.

China's sovereign bonds are rated BBB by S&P, which puts China somewhere in the middle of developing Asian economies (below Korea, above Thailand, and on a par with Malaysia). China's rating is helped by its impressive external position: it holds over $230 billion in foreign reserves, more than it has borrowed from foreign creditors. The rating also reflects China's impressive commitment to the reform of virtually every aspect of its economy, which has given investors confidence in its prospects as an international borrower.

China's rating is relatively low for a country with such a strong external position, primarily because of the huge amounts of government debt buried in the banking system. When the non-performing loans on the books of state commercial banks are factored in as government debt, China's government debt is estimated at roughly 70% of GDP, on par with India. S&P estimates the total cost of bailing out China's banks at anywhere from 43% to 86% of GDP, an astronomical amount. Additionally, as the government continues to tackle major financial fiscal burdens, particularly pension liabilities, its fiscal health will face an increasingly risky future. The government's lack of transparency concerning its public finances only adds to this sense of risk.

Mr. Mukherji agreed with the other panelists that China's bond market has the potential to become significant down the road for reasons that also apply to the equity markets: the large amount of domestic savings, government assets that investors want, a market in Hong Kong which essentially allows listings to be tested in advance, and so forth. But the market also contains a lot of risk and a weak regulatory framework, both of which may give investors pause for the near future.

Conclusion

China's capital markets have made great strides in recent years, and now attract the attention of investors worldwide. Yet virtually every aspect of the financial markets, from the equity markets to the debt markets, has a long way to go before they will compel international investors to commit significant amounts of capital. The near-term opportunities in the market, especially for foreign investors, are few and far between. Nevertheless, the sense from the conference was that one should be optimistic about China's potential and that, in spite of all of the uncertainties, financial services firms should position themselves to capitalize on the opening of the markets that will come once China lives up to its WTO commitments.